BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Docket No. 41191 (Sub-No. 1)

AEP TEXAS NORTH COMPANY

v.

BNSF RAILWAY COMPANY

Fourth Supplemental Reply Evidence of BNSF Railway Company

NARRATIVE & EXHIBITS

Volume I of I

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ABBREVIATIONS

TERMS:

AAR	Association of American Railroads
AEP Texas	AEP Texas North Company
ATC	Average Total Cost
BNSF	BNSF Railway Company
CAPM	Capital Asset Pricing Model
DCF	Discounted Cash Flow
ICC	Interstate Commerce Commission
MMM	Maximum Markup Methodology
Nar.	Narrative
R/VC	Revenue-To-Variable Cost
SAC	Stand-Alone Cost
SARR	Stand-Alone Railroad
URCS	Uniform Rail Costing System

CASE NAMES

September 2007 Decision	*AEP Texas North Co. v. BNSF Railway Co.*, STB Docket No. 41191 (Sub-No. 1) (STB served Sept. 10, 2007).
May 2008 Decision	*AEP Texas North Co. v. BNSF Railway Co.*, STB Docket No. 41191 (Sub-No. 1) (STB served May 29, 2008).
August 2008 Decision	*Use of a Multi-Stage Discounted Cash Flow Model in Determining The Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (Sub-No. 1) (STB served Aug. 11, 2008).
Major Issues	*Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No.1) (STB served Oct. 30, 2006).
Ex Parte No. 664	*Methodology to be Employed in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (STB served Jan. 17, 2008).
WCTL v. STB	*Western Coal Traffic League v. Surface Transportation Board*, 264 Fed. App'x 7, No. 07-1064 (D.C. Cir. Feb. 1, 2008).

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Fourth Supplemental Reply Evidence of BNSF Railway Company

Pursuant to the Board's May 29, 2008 and June 18, 2008 decisions in this proceeding, BNSF Railway Company ("BNSF") hereby submits its Fourth Supplemental Reply Evidence in response to the Opening Fourth Supplemental Evidence filed by AEP Texas North Company ("AEP Texas") on August 8, 2008. This supplemental reply evidence is limited to the following four issues: (1) whether the Board should modify its approach to calculating the SARR's cost of capital in light of the Board's recent change in the methodology for determining the railroad industry cost of equity capital; (2) certain technical corrections proposed by AEP Texas in its Opening Fourth Supplemental Evidence to the Board's decision in *AEP Texas North Co. v. BNSF Railway Co*., STB Docket No. 41191 (Sub-No.1) (STB served Sept. 10, 2007) ("*September 2007 Decision*"); (3) certain changes to URCS costs that AEP Texas proposes to use in restating SAC results; and (4) how the Boards' Maximum Markup Methodology ("MMM") should be implemented, if necessary, in this case.

BNSF also updates the summary SAC results that BNSF presented in its opening supplemental evidence in response to the technical corrections proposed by AEP Texas. As discussed below, under the Board's existing methodology for assessing a SARR's cost of capital, which the Board should continue to apply in this case, SAC costs exceed revenues and the Board should therefore dismiss AEP Texas' complaint.

I. COST OF CAPITAL

As BNSF explained in its Fourth Supplemental Evidence, the Board should continue to determine the SARR's historical years' cost of capital (1998-2006 or 2007 if available) based on the railroad industry cost of capital for those years as determined by the Board in Ex Parte No. 558, and the Board should estimate the SARR's future cost of capital based on an average of all relevant historical years' cost of capital. The Board should not restate the 1998 through 2005 cost of capital determinations made in Ex Parte No. 558 for use in this case to reflect a cost of equity based on CAPM. The Board has already determined the industry cost of capital for those years in separate annual proceedings and it would be inappropriate to use this rate case as a collateral challenge to the validity of those prior determinations. BNSF also explained that the Board should continue to forecast the SARR's cost of capital for future years by using the average of the Board-determined industry cost of capital for all relevant years.

Since the filing of BNSF's Fourth Supplemental Evidence, the Board issued a decision in *Use of a Multi-Stage Discounted Cash Flow Model in Determining The Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (Sub-No. 1) (STB served Aug. 11, 2008) ("*August 2008 Decision*"), that reinforces BNSF's position that the Board should not change its established approach to the calculation of the SARR's cost of capital in this case. In the *August 2008 Decision*, the Board proposed "to determine the cost of equity of the railroad industry by using the average of the estimate produced by the CAPM model and the Morningstar/Ibbotson multi-stage DCF model identified by AAR." *Id.* at 4. As justification for its proposal, the Board indicated that "in many cases, combining forecasts from different models is more accurate than relying on a single model." *Id.* at 3. The Board also examined prior year results using the CAPM and an average of the CAPM and multi-stage DCF models and concluded that "using the average of both CAPM and the multi-stage DCF model produces a more stable and more precise

cost-of-equity estimate." *Id.* at 5. The Board's analysis further showed that for the years 1998 through 2006, the CAPM-only estimate systematically understated the cost of equity capital.[1]

In light of the Board's conclusions in its *August 2008 Decision* and its proposed rule, it would be irrational and arbitrary to restate the industry cost of capital in this case using a CAPM-based cost of equity. The Board indicated in the *August 2008 Decision* that it does not intend to rely solely on the CAPM methodology out of concern that a CAPM-based estimate, standing alone, is less reliable than an estimate based on the average of a CAPM and multi-stage DCF estimate. Given that conclusion, it would be fundamentally irrational to restate settled historical year cost of capital determinations using a CAPM-only methodology.

As discussed below, AEP Texas' primary argument for restating historical year cost of capital determinations for use in this case is that the Board has found the CAPM methodology to be "the superior methodology for determining the cost of equity." AEP Texas Opening Fourth Supp. at 4. AEP Texas mischaracterizes the Board's conclusions, which never addressed the merits of CAPM-based cost of capital estimates as applied to years before 2006. In any event, AEP Texas' claim is obviously untenable in light of the Board's acknowledgement in the *August 2008 Decision* that a CAPM-only approach produces less reliable results than an approach based on the average of CAPM and multi-stage DCF estimates.

AEP Texas' argument that a restatement of prior year cost of capital determinations would be consistent with precedent is also wrong. As BNSF explained in its opening supplemental evidence, it would be directly contrary to longstanding precedent and legal

[1] The Board's analysis indicates that for 1998 through 2006, CAPM produced estimates of a cost of equity between 9.7% and 12.7%; the multi-stage DCF produced estimates between 11.6% and 14.6%; and the average of the two results ranged between 11.1% and 13.4%. *August 2008 Decision* at 5. BNSF notes that the CAPM estimate of 12.7% and the 13.4% average are actually for the year 2007. *See* Comments of the Association of American Railroads, at Exhibit 3, STB Ex Parte No. 664 (Sub-No. 1) (filed Apr. 14, 2008).

principles set down by the Supreme Court for the Board to disregard prior year cost of capital determinations and allow the validity of those determinations to be collaterally challenged in the context of a rate case.

In short, the Board should make no change to the cost of capital assumptions used in the Board's *September 2007 Decision* in this proceeding except to update its calculations to include the 2006 and, if available 2007, railroad industry cost of capital determinations and to revise its estimate of the SARR's future year cost of capital to include in the average of historical years the more recent cost of capital determinations.

A. There Is No Evidence In The Record Of This Or Any Other Proceeding That A CAPM-Only Methodology Would Produce Accurate Or Superior Cost Of Capital Estimates For Historical Years.

The primary thrust of AEP Texas' argument in favor of restating the industry cost of capital for 1998 through 2005 based on CAPM is that CAPM is "superior" to and produces "more accurate" results than the DCF method that the Board used when it made its annual cost of capital determinations for those years. The premise of AEP Texas' argument -- that it is permissible to conduct a de novo review of prior year cost of capital determinations in individual rate cases -- is wrong for reasons discussed below. In any event, AEP Texas' argument about the "superiority" of CAPM mischaracterizes the Board's prior conclusions regarding the CAPM and DCF models.

When the Board initiated a rulemaking proceeding to consider changes to its existing cost of capital methodology, it did not justify its action based on any evidence that the existing DCF methodology had produced inaccurate or flawed results for any particular year. Indeed, the Board expressly stated that "our decision to conduct a broader rulemaking is not an admission that the existing approach is flawed, but instead a prudent exercise of our regulatory authority to explore whether there are superior alternatives available. . . ." *Cost of Capital – 2005*, STB Ex

Parte No. 558 (Sub-No. 9), slip op. at 3-4 n.2 (STB served Feb. 12, 2007). The only question before the Board was what approach should be used for making future (*i.e.*, post-2005) cost of capital determinations. And the only conclusion reached by the Board was that the CAPM model "is a more current approach that commands great respect in the regulatory and academic community . . . [and therefore] provides a suitable alternative to the 1981 DCF model. . . ." *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (STB served Jan. 17, 2008) ("*Ex Parte No. 664*").

The Board never examined the issue of whether the CAPM model would have produced results superior to those produced by the DCF model for any historical years. Therefore, there is no evidence that supports AEP Texas' claim that CAPM is a superior methodology as applied to historical years. For the period 1998 to 2005, the only year in which shippers challenged the validity of the DCF-based results was 2005, and in that annual proceeding, the Board concluded that the evidence was inadequate to justify a departure from its DCF approach. *See Ex Parte No. 664* at 4 ("the record in the 2005 proceeding was too bare to support a departure from two decades of established agency precedent"). The evidence in the 2005 proceeding has not been supplemented, nor has any party submitted new evidence in any other annual cost of capital proceeding for the relevant years demonstrating that a non-DCF approach should have been used.

Whether a DCF- or CAPM-based estimate would be more accurate or appropriate for a particular year in the past cannot be answered in the abstract. The circumstances of particular years would have to be considered. The Board concluded that in some years, the DCF model might overstate the cost of equity and in other instances it might understate the cost of equity. But the record also shows that the CAPM model produces widely varying results. As BNSF's

finance experts pointed out in their verified statement in support of BNSF's opening supplemental evidence, the CAPM-based cost of capital dropped 43 percent from 1994 to 2003, a substantial change that should raise questions about the accuracy of a CAPM-only estimate for any particular year during that period. *See* Hamada/Gokhale V.S. at ¶ 24. It is unlikely that investors' expectations changed as significantly as suggested by these changes in CAPM results, but there is no way to determine in the abstract whether the broad changes resulted from estimates in particular years that were too high or estimates in other years that were too low. The betas used in the CAPM methodology also varied significantly during this time period, in part due to anomalies caused by the technology bubble. *Id*.

The circumstances of particular historical years would have to be considered before any rational conclusion could be reached about the relative "superiority" of a CAPM-based estimate for that year. There has never been an examination of those circumstances.[2] It is one thing for the Board to adopt the CAPM model going forward based on a conclusion that CAPM has become a more widely accepted model. It is quite another thing to assume, without any examination of evidence, that the CAPM model would produce superior results in particular historical years and to reach back and change the cost of capital determinations that the Board has already made for those years. The Board never reached such a conclusion about the

[2] As BNSF explained in its opening supplemental comments, BNSF does not believe that it would be permissible to retroactively change a prior year cost of capital determination under any circumstances. *See* BNSF Opening Fourth Supp. at 12-17. But if any retroactive change could be made, it would have to be made through a formal reopening of the prior cost of capital determination. A reopening would allow the parties to submit evidence on the question of which approach was "superior" for a particular year, rather than rely on conjecture and abstractions as AEP Texas proposes here. The D.C. Circuit clearly expected that the question whether a change could be made to a prior year cost of capital determination would be addressed in the context of a formal reopening of the particular cost of capital proceeding. *Western Coal Traffic League v. Surface Transportation Board*, 264 Fed. App'x 7, 8-9, No. 07-1064 (D.C. Cir. Feb. 1, 2008) ("*WCTL v. STB*").

superiority of CAPM as applied in historical years and there is no evidence that would support such a conclusion in this case.

B. Application Of A Restated Railroad Industry Cost Of Capital In This Rate Case Would Be Directly Contrary To Precedent.

AEP Texas also argues that it would be consistent with precedent for the Board to restate the railroad industry cost of capital for years prior to 2006 using the CAPM methodology and to use the restated cost of capital in its pending rate case. AEP Texas relies principally on the Board's decision in *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No.1) (STB served Oct. 30, 2006) ("*Major Issues*"), where the Board adopted new SAC methodologies and decided to apply those new methodologies in the pending rate cases. AEP Texas' reliance on the Board's decision in *Major Issues* is misplaced.

Major Issues addressed changes in methodologies used to adjudicate rate reasonableness cases under the SAC test. As BNSF noted on opening, within certain limits, agencies may change the methodologies they use to adjudicate disputes and apply those new methodologies in pending cases. *See* BNSF Opening Fourth Supp. at 17. But no one is suggesting that the Board change the existing SAC methodology for determining a SARR's cost of capital. The Board's longstanding practice is to assume that a SARR's cost of capital is the same as the railroad industry cost of capital. While the Board could decide to reconsider that basic SAC assumption, if it did, it would have to examine evidence relating to numerous factors that would affect the SARR's cost of capital independent of the railroad industry cost of capital. For example, it would be necessary to consider the impact on the cost of capital of the SARR's heavy dependence in this case on the transportation of a single commodity. There is no evidence in this case that would justify an independent evaluation of the SARR's cost of capital because neither

the Board nor AEP Texas has proposed to change the basic SAC assumption that a SARR's cost of capital is the same as the railroad industry's cost of capital.

AEP Texas simply asks the Board to ignore the Board's prior determinations of the industry cost of capital and make new railroad industry cost of capital determinations in the context of the pending rate case. The Board's decision in *Major Issues* does not support AEP Texas' approach. To the contrary, the Board in *Major Issues* made it clear that determinations made in different proceedings cannot be collaterally attacked in a SAC case. *See Major Issues* at 59 (a change to URCS "should only be considered in a separate rulemaking proceeding, where the specific proposals would be subject to public comment and, if adopted, uniform application"). This conclusion in *Major Issues* reflects the Board's longstanding practice. As BNSF explained in its opening supplemental evidence, the Board has repeatedly stated that its cost of capital determinations (like other determinations made in separate dockets but used in SAC cases) are not up for grabs in individual rate cases. *See FMC Wyoming Corp. and FMC Corp. v. Union Pacific Railroad Co*., STB Docket No. 42022, slip op. at 178-79 (STB served May 12, 2000); *Wisconsin Power and Light Company v. Union Pacific Railroad Company*, STB Docket No. 42051, slip op. at 31-33 (STB served May 14, 2002).[3]

AEP Texas also ignores longstanding case law, described by BNSF in its opening supplemental evidence, establishing that an agency is bound by determinations made pursuant to delegated, quasi-legislative authority and that the agency cannot ignore or disregard those determinations in adjudicating individual disputes. *See* BNSF Opening Fourth Supp. at 12-17. This principal has its roots in *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Railway Co*.,

[3] One reason for this longstanding precedent is that it allows the Board to bring rate cases to closure. Indeed, if the Board were to restate settled cost of capital determinations using CAPM, BNSF would have every incentive to seek yet another restatement based on the new CAPM/multi-stage DCF approach that the Board has proposed.

284 U.S. 370 (1932). Thus, when the Board's annual cost of capital determinations become final, they have the force of law and are binding on the Board and on parties to proceedings before the Board. The Board is simply not free to ignore those determinations on an ad hoc basis.

Arizona Grocery also suggests that once a cost of capital determination is made for a particular year, it would not be permissible retroactively to reach back and change that determination. However, as BNSF explained, even if a final cost of capital determination could be retroactively changed, such a change would have to be made through a formal reopening and revision of the Board's prior determination. It would not be permissible for the Board simply to ignore its prior determinations and assume a railroad cost of capital that is inconsistent with those prior determinations in the context of a rate case.

AEP Texas cites three cases in addition to *Major Issues* as precedent for the restating of the cost of capital determinations reached in other dockets for purposes of this rate case. Two of those cases – *Simplified Standards for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No.1) (STB served Sept. 5, 2007), and *Wisconsin Power and Light Co. v. Union Pacific R.R. Co*., Docket No. 42051 (STB served Apr. 24, 2000) – involve the same basic circumstances as *Major Issues*. Both cases dealt with a change in rate reasonableness methodologies and the application of those changes in pending cases. Neither case involved retroactive changes to final determinations in dockets independent of rate reasonableness proceedings and neither case indicated that it is permissible to ignore final determinations made in other dockets in assessing the reasonableness of challenged rates.

In the third case cited by AEP Texas – *Arkansas Power & Light Co. v. Burlington N. R.R. Co.*, 3 I.C.C.2d 757 (1987) – the parties submitted rate reasonableness evidence relating to the

revenue adequacy and managerial efficiency constraints of Constrained Market Pricing as well as SAC evidence. On the revenue adequacy constraint, the complainant challenged the ICC's findings in separate dockets that the defendant railroads were not revenue adequate. The ICC rejected the complainant's evidence, noting that "[t]his is a collateral attack on the standard adopted there [in the revenue adequacy docket] which we reject." *Id*. at 765. The ICC went on to note that it had recently changed the standards for assessing a railroad's revenue adequacy and that under the new standard, the defendants would still be considered revenue inadequate. However, the ICC did not rule that the new standards could be used to modify prior revenue adequacy findings. To the contrary, the ICC noted that the question of retroactivity did not need to be considered because any retroactive application of the new standard would have made no difference in the results. *Id*. ("Even if those changes were applied retroactively, BN and MP still earned inadequate revenues for the years in question.") Because the ICC never reached the issue of whether the new standards could be used retroactively to produce results inconsistent with prior determinations, the *Arkansas Power* case is not precedent for a restatement of prior cost of capital determinations.

Finally, AEP Texas incorrectly asserts that the Board has already acknowledged that the Board's railroad industry cost of capital determinations for prior years can be disregarded in the context of individual rate cases, citing certain statements by Board counsel to the D.C. Circuit in *WCTL v. STB*, No. 07-1064 (D.C. Cir.). *See* AEP Texas Opening Fourth Supp. at 22-23. AEP Texas mischaracterizes the Board counsel's statements. In the cited statements, the Board's counsel simply indicated that the Board would consider the restatement of prior year cost of capital determinations in the context of pending rate cases if requested to do so by a party to the rate case. Indeed, the Board in this case has called for the current round of supplemental

evidence to address the cost of capital issue so that a decision could be reached on the basis of a full record. The Board never indicated that the restatement of settled cost of capital determinations in individual rate cases would be permissible. In any event, regardless of what the Board's counsel represented to the court, the court indicated that it expected that any challenge to the Board's 2005 cost of capital determination would be pursued through a reopening of the cost of capital docket. *WCTL v. STB*, 264 Fed. App'x 7, 8-9 (D.C. Cir. Feb. 1, 2008).

C. There Would Be No Justification For Restating Only The 2005 Cost Of Capital.

AEP Texas' fallback position is that the Board should "at a minimum" restate the 2005 cost of capital using the CAPM model. AEP Texas Opening Fourth Supp. at 23. But there is no basis for treating 2005 differently from other historical years. It is true that 2005 is the only year for which any evidence was submitted on the question of the accuracy of the DCF-based cost of capital results. But the Board specifically concluded in that proceeding that the evidence was not sufficient to justify a departure from its DCF approach. *See Ex Parte No. 664* at 4 ("the record in the 2005 proceeding was too bare to support a departure from two decades of established agency precedent"). As noted above, the evidence in the 2005 proceeding has not been supplemented, nor has any party submitted new evidence in any other proceeding demonstrating that a non-DCF approach should have been used for 2005.[4]

In support of its claim that the 2005 cost of capital should be restated, AEP Texas once again mischaracterizes statements made by the Board's counsel to the D.C. Circuit in the *WCTL*

[4] The fact that the implicit growth rate used in the DCF model exceeded the expected growth rate of the economy may have been enough to raise a question about the Board's continued use of the DCF model, but the Board concluded that it was not enough to prove that the DCF model produced flawed cost of capital estimates for any particular year.

v. STB appeal. Contrary to AEP Texas' claim, the Board's counsel did not state that the Board would change the 2005 cost of capital if the new CAPM methodology was shown to have a material impact on the rate reasonableness analysis. The Board's counsel said only that AEP Texas would be able to raise its concerns in a reopening of its individual rate case if it could show that the new methodology had a material impact on the rate reasonableness results. The Board subsequently called for new evidence and argument on the issue, which is the subject of this round of Fourth Supplemental Evidence. The Board did not prejudge the conclusions it would reach after full consideration of the issue. Moreover, the Board obviously did not know at the time of the oral argument in *WCTL v. STB* that it would subsequently conclude that it could achieve greater accuracy in estimating the cost of capital using a combined CAPM and multi-stage DCF approach.

D. The Board Should Continue To Use An Average Of All Relevant Historical Year Cost Of Capital Determinations To Forecast The SARR's Future Year Cost Of Capital.

BNSF explained in its opening supplemental evidence that the Board adopted its current practice of basing future year cost of capital forecasts on an average of several prior year determinations to avoid distortions that would result from using a single year or a small number of years as the basis for a forecast that would reach several years into the future. That concern alone should dissuade the Board from adopting a forecast of the SARR's cost of capital in this case based only on the 2006 and possible 2007 CAPM-based cost of capital determinations. More important, sole reliance on the 2006 and possibly 2007 cost of capital determinations to forecast the SARR's future years' cost of capital would give improper emphasis to estimates based on a methodology that the Board intends to modify going forward.

The methodology that the Board has proposed to use for future years is an average of the CAPM results and the results of a multi-stage DCF model. Since the Board no longer intends to

rely exclusively on a CAPM-based estimate, the use of CAPM-based estimates for 2006 and possibly 2007 alone are not likely to reliably estimate the future cost of capital determinations that the Board would reach using the multi-factor approach. The data presented by the Board in the *August 2008 Decision* show that a CAPM-only estimate may well understate future year cost of capital estimates made using the new multi-factor analysis, since CAPM estimates for individual years are consistently lower than the multi-factor estimates. *See August 2008 Decision* at 5.

Indeed, the 2006 CAPM-based cost of equity, which AEP Texas urges the Board to use to estimate the SARR's future years' cost of capital, is only 11.1%, whereas the Board estimates that the multi-factor analysis for 2007 would produce a 13.4% cost of equity.[5] Therefore, it is clear that AEP Texas' approach would produce an invalid estimate of the 2007 results if the Board were to adopt the multi-factor approach for 2007. Moreover, the Board's *August 2008 Decision* estimates the CAPM-based cost of equity for 2007 to be 12.7%, compared to the 2006 CAPM estimate of 11.1%. Therefore, it is also clear that AEP Texas' approach (reliance on 2006 alone to forecast the SARR's future cost of capital) would produce an invalid estimate of the 2007 results even if the Board continued to use the CAPM model for 2007. By contrast, the simple average of actual 1998-2006 cost of equity determinations (13.1%) is quite close to the Board's assumption of the multi-factor cost of equity estimate for 2007 (13.4%) and only slightly higher than the CAPM-only estimate for that year (12.7%). These data suggest that use of the Board's existing methodology is the best and most reliable approach for forecasting the SARR's future years' cost of capital.

[5] As noted previously, the Board's *August 2008 Decision* mistakenly attributes this cost of equity to the year 2006, but it is clearly an estimate of the multi-factor results for the year 2007. *See* Comments of the Association of American Railroads, at Exhibit 3, STB Ex Parte No. 664 (Sub-No. 1) (filed Apr. 14, 2008).

AEP Texas argues that the Board could not continue to apply its existing methodology to forecast the SARR's cost of capital because that methodology would "perpetuate an untenable growth rate" for the SARR. AEP Texas Opening Fourth Supp. at 25 and Table 1. This argument makes no sense. The revenue growth rate of the SARR has nothing to do with the Board's cost of capital determinations. The purpose of the Board's forecast methodology is to estimate the likely future year cost of capital of the railroad industry, since the SARR's cost of capital is assumed to be the same as the railroad industry's cost of capital. The Board has properly concluded that an average of several historical years' cost of capital is the best evidence of the railroad industry's likely future years' cost of capital. That approach continues to be the best methodology for forecasting the railroad industry cost of capital and it should be used in this case.

II. TECHNICAL CORRECTIONS

A. Big Cajun Forecasted Revenues

BNSF accepts the revenue correction proffered by AEP Texas with respect to shipments to the Big Cajun plant.

B. Equity Flotation Cost

AEP Texas proposes to eliminate the equity flotation cost included in the Board's SAC calculations on the grounds that the Board rejected AEP Texas' proposed refinancing of the SARR's debt, and that this rejection also amounted to a rejection of imposing any equity flotation cost. AEP Texas' proposal addresses a substantive issue and is not a request for a technical correction. Moreover, it is based on a misreading of the Board's *September 2007 Decision.*

AEP Texas confuses two issues. AEP Texas is correct that the Board rejected its evidence concerning the feasibility of the SARR refinancing its debt. *September 2007 Decision*

at 106-07. AEP Texas is wrong, however, that the Board addressed equity flotation costs as part of the discussion of debt refinancing. Instead, the Board separately addressed whether an equity flotation cost should be added. The Board declined to accept BNSF's evidence that an equity flotation cost of 4% should be added to the SARR's investment base but it expressly adopted AEP Texas' approach to calculating the equity flotation cost that would be added to the cost of equity in relevant years. *Id.* at 107. As the Board stated:

> AEP Texas agrees that an equity flotation fee should be included . . . . AEP Texas instead derives the equity flotation fee by looking at the fee from the Board's cost-of-capital decision in the year in which a new equity was last issued (1991), then multiplying that percentage by the percentage contribution of the issuing carriers' market valuation to the overall industry market valuation. AEP Texas asserts that this calculated percentage should then be added to the weighted industry-average cost of equity capital . . . .

Id.[6]

Clearly AEP Texas' proposed modification is not a "correction" because the Board did what it said it would: it accepted an equity flotation cost and included it in the SAC calculations. It is inappropriate for AEP Texas to attempt to relitigate this issue here. In any case, AEP Texas is wrong about what the Board held and has offered no evidence that an equity flotation cost would not be incurred by the SARR. Therefore, there is no basis for making the adjustment proposed by AEP Texas.[7]

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[6] AEP Texas' current contention that inclusion of an *equity* flotation cost is somehow contingent upon the SARR's ability to refinance *debt*, AEP Texas Opening Fourth Supplemental Evidence at 38, is not consistent with the Board's decision or AEP Texas' earlier evidence on the issue. *See* AEP Texas Rebuttal Evidence at III-G-3 through III-G-5 (filed July 24, 2004).

[7] In the course of addressing AEP Texas' proposed technical correction, BNSF discovered that in its Fourth Supplemental Evidence, BNSF inadvertently failed to add the equity flotation percentage to the weighted industry-average cost of equity capital for 1998 through 2000 in the scenario where a CAPM cost of equity was used for those years. In this Fourth Supplemental Reply Evidence, the restated results for that scenario include the correctly adjusted CAPM cost of equity for those years.

III. ADJUSTMENTS TO URCS PROPOSED BY AEP TEXAS

AEP Texas proposes updating URCS Phase III variable costs to incorporate the CAPM cost of equity for 1998 through 2005. Doing so has the effect of modifying the revenues the SARR receives under ATC, the calculated MMM rates, and the "jurisdictional threshold" AEP Texas reports in its Opening Fourth Supplemental Evidence in Table 8, at 40. All of these proposed adjustments are improper and outside the scope of this proceeding.

First, the scope of this proceeding is very limited. The Board denied the petitions for reconsideration filed by both parties with the sole exception of the issue of what cost of capital should be used in the DCF calculation. The Board directed each party to submit new SAC calculations, one using the cost of capital figures determined by the Board for all periods and one restating the cost of capital using CAPM for the years 1998 through 2005. The Board further directed the parties to comment on what procedures should be used to forecast the cost of capital used in the DCF. Finally, the Board directed the parties to submit MMM calculations if any set of SAC results indicated that SARR revenues exceeded SAC costs. *AEP Texas North Co. v. BNSF Railway Co.*, STB Docket No. 41191 (Sub-No. 1), slip op. at 7-8 (STB served May 29, 2008) ("*May 2008 Decision*").

The Board did not direct the parties to recalculate URCS or to recalculate ATC, which uses URCS variable cost calculations. Nor did the Board direct the parties to recalculate the variable costs used in MMM. Neither AEP Texas, in seeking reconsideration, nor the Board, in calling for supplemental evidence, mentioned a word about the possible restatement of the jurisdictional threshold or any expansion of the Board's jurisdiction over the rates at issue. All of the modifications made by AEP Texas with respect to URCS are therefore outside the scope of permissible evidence.

Second, the Board expressly found in the *September 2007 Decision* that the URCS costs to be used in this case were those for 2004. *September 2007 Decision* at 12-13. The Board has already determined what the unadjusted URCS costs for BNSF are for 2004 for purposes of using URCS in regulatory applications and the Board has not modified the previously established URCS costs to reflect a lower CAPM-based cost of equity. As the Board acknowledged in *Major Issues*, it is not appropriate to collaterally attack the basic URCS cost assumptions and calculations on an ad hoc basis in individual cases. *Major Issues* at 59. Moreover, AEP Texas did not petition the Board to reconsider this aspect of its decision and the issue is not open to relitigation.

Third, there is no evidentiary basis to support modifying URCS calculations for prior years to reflect a CAPM cost of equity. As discussed above, the CAPM model was adopted for use in 2006 and future years only and the Board never made any determination as to the appropriateness of CAPM-based estimates for prior years. There is simply no evidentiary support for the proposition that CAPM produces a more accurate estimate of the cost of equity for 2004 than the Board's DCF model. Indeed, the Board's *August 2008 Decision* indicates that CAPM may consistently understate the cost of equity and suggests that a more accurate estimate is possible when a multi-stage DCF is used in conjunction with CAPM. It would be arbitrary and irrational to restate URCS for 2004 given the lack of evidence that CAPM would produce a more accurate result than the methodology in place at the time the Board made its 2004 determination and given the recently expressed reservations regarding the accuracy of an estimate based solely on CAPM.

IV. RESULTS OF ALTERNATIVE SAC ANALYSES

In its Fourth Supplemental Evidence, BNSF reported SAC results under three scenarios. BNSF first presented SAC results under the Board's existing cost of capital approach: the

industry cost of capital determined by the Board was used for 1998 through 2006, the AAR's CAPM-based cost of capital calculations for 2007 were used for 2007, and future cost of capital was forecast based on the average of figures for 1998 through 2007. BNSF also presented two alternative scenarios. The first alternative scenario used the industry cost of capital determined by the Board for 1998 through 2006 and the AAR cost of capital calculations for 2007, and it forecast the future cost of capital using only the 2006 and 2007 figures. The second alternative scenario restated the industry cost of capital for 1998 through 2005 based on a CAPM cost of equity and used the average of the 1998 through 2007 cost of capital for future years.[8] BNSF continues to believe that the Board should not restate the industry cost of capital for 1998 through 2005 and should forecast future years based on an average of all relevant historical years.

Below, BNSF restates the SAC results from its Fourth Supplemental Evidence to reflect the technical change relating to Big Cajun revenues and the inclusion of the equity finance fee that was inadvertently left out of BNSF's second alternative SAC calculations in the opening supplemental evidence.

[8] For this alternative, BNSF used the CAPM calculations of its finance experts Professor Hamada and Mr. Gokhale. There are slight differences between BNSF's CAPM calculations and those submitted by AEP Texas that appear to be attributable to the use of different data sources. While BNSF does not believe any restatement of prior year results would be appropriate, BNSF stands by its prior CAPM estimates.

Table 1[9]
SAC Results Under Existing STB Approach
(Millions of Dollars)

Year	SARR Revenue Requirement	SARR Revenues	Overpayments (Shortfalls)	Present Value
2000	$372.7	$384.1	$11.4	$11.3
2001	680.6	711.1	30.5	28.0
2002	680.0	721.0	41.0	34.0
2003	694.8	695.2	0.3	0.4
2004	738.4	732.5	(6.0)	(3.9)
2005	775.2	740.2	(35.0)	(19.2)
2006	808.7	766.9	(41.8)	(23.6)
2007	828.3	792.1	(36.2)	(17.4)
2008	839.6	800.2	(39.3)	(16.9)
2009	855.8	825.6	(30.2)	(11.7)
2010	866.6	837.9	(28.7)	(10.0)
2011	886.6	864.3	(22.3)	(7.0)
2012	906.0	908.9	2.9	0.8
2013	926.5	933.3	6.8	1.7
2014	946.3	953.5	7.3	1.7
2015	963.1	965.9	2.8	0.6
2016	985.2	991.9	6.7	1.3
2017	1,010.1	1,024.7	14.6	2.5
2018	1,035.3	1,057.8	22.5	3.5
2019	1,060.3	1,092.0	31.7	4.4
2020	1,094.0	1,142.4	48.4	6.1
Cumulative Net Present Value				**($13.5)**

[9] BNSF Fourth Supplemental Reply workpaper "BNSF 6-15-06 Supplemental Reply Exhibit III.H-1_STB 10 year Average Reply.xls."

Table 2[10]
SAC Results for First Alternative Scenario
(Millions of Dollars)

Year	SARR Revenue Requirement	SARR Revenues	Overpayments (Shortfalls)	Present Value
2000	$368.1	$384.1	$16.0	$15.9
2001	671.7	711.1	39.4	36.1
2002	671.0	721.0	50.0	41.5
2003	685.6	695.2	9.5	7.3
2004	728.8	732.5	3.6	2.3
2005	765.2	740.2	(25.1)	(13.8)
2006	798.3	766.9	(31.4)	(17.7)
2007	817.6	792.1	(25.6)	(12.3)
2008	828.7	800.2	(28.5)	(12.9)
2009	844.8	825.6	(19.2)	(7.9)
2010	855.4	837.9	(17.6)	(6.5)
2011	875.2	864.3	(10.9)	(3.7)
2012	894.4	908.9	14.5	4.5
2013	914.6	933.3	18.7	5.2
2014	934.0	953.5	19.5	5.0
2015	950.5	965.9	15.4	3.6
2016	972.3	991.9	19.6	4.1
2017	996.9	1,024.7	27.8	5.3
2018	1,021.7	1,057.8	36.2	6.2
2019	1,046.3	1,092.0	45.7	7.2
2020	1,079.7	1,142.4	62.7	8.9
Cumulative Net Present Value				**$78.3**

[10] BNSF Fourth Supplemental Reply workpaper "BNSF 6-15-06 Supplemental Reply Exhibit III.H-1_STB 06-07 Average Reply.xls."

Table 3[11]
SAC Results for Second Alternative Scenario
(Millions of Dollars)

Year	SARR Revenue Requirement	SARR Revenues	Overpayments (Shortfalls)	Present Value
2000	$348.7	$384.1	$35.4	$35.1
2001	634.9	711.1	76.3	70.6
2002	633.5	721.0	87.5	74.7
2003	647.2	695.2	47.9	37.7
2004	688.6	732.5	43.8	30.3
2005	723.7	740.2	16.5	10.4
2006	754.7	766.9	12.2	6.9
2007	773.1	792.1	19.0	9.2
2008	783.4	800.2	16.8	7.9
2009	798.8	825.6	26.8	11.5
2010	808.7	837.9	29.2	11.4
2011	827.7	864.3	36.6	13.0
2012	845.8	908.9	63.0	20.5
2013	864.8	933.3	68.5	20.3
2014	882.9	953.5	70.7	19.1
2015	897.9	965.9	68.0	16.8
2016	918.3	991.9	73.6	16.6
2017	941.5	1,024.7	83.3	17.1
2018	964.8	1,057.8	93.1	17.5
2019	987.9	1,092.0	104.1	17.8
2020	1,019.7	1,142.4	122.8	19.2
Cumulative Net Present Value				**$483.6**

V. APPLICATION OF MMM

AEP Texas does not provide any narrative description or justification of its methodology for applying MMM. Its "evidence" is limited to two tables presented in the text of its Opening Fourth Supplemental Evidence (at 36 and 40), with all details left to its workpapers.

[11] BNSF Fourth Supplemental Reply workpaper "BNSF 6-15-06 Supplemental Reply Exhibit III.H-1_STB CAPM Reply.xls."

Nonetheless, there are several obvious problems with AEP Texas' approach to calculating MMM rates.

A. MMM Requires Calculation Of Mine-Specific Rates.

AEP Texas presents a single MMM rate that it apparently would apply to all issue traffic movements. Use of an average rate for all relevant mine origins is inconsistent with the principles underlying MMM. MMM is based on capping rates according to the ratio of revenues to variable costs. Where the SARR exhibits an overcharge based on existing rates, the overcharge is eliminated by capping all rates above a calculated threshold at a common R/VC level. Variable costs per ton vary substantially by mine origin.[12] Because MMM uses variable costs and R/VC ratios to set rates, MMM results would be distorted if the differences in variable costs among movements involving different mine origins were ignored. Imposing a single rate for all mine origins would also create improperly preferential rates for movements from mines where the actual variable costs are above the weighted-average variable cost. Since MMM bases rates on variable costs, movements from mines with variable costs that are higher than the weighted-average variable cost would have higher rates per ton than a single rate based on weighted-average variable costs.[13]

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[12] *See, e.g.,* BNSF Third Supplemental Reply Evidence, Exhibit RTS_1 at 1-2 (filed Mar. 19, 2007) (reporting 1Q '05 unadjusted URCS Phase III variable costs ranging from $9.36 per ton to $10.72 per ton, depending on mine origin).

[13] As BNSF pointed out in the *Western Fuels Association v. BNSF Railway Company* proceeding, using an average rate permits a shipper to intentionally manipulate both reparations and future rates by using one set of assumptions for its SAC analysis and then making actual shipments in a different pattern that allows the shipper to gain excess reparations or ship at cheaper rates from mines that have higher variable costs. *See* Third Supplemental Reply Evidence of BNSF Railway Company, STB Docket No. 42088, at III.H-6 through III.H-7, III.H-21 through III.H-22 (filed July 14, 2008).

B. AEP Texas Calculated URCS Costs For The Issue Traffic Using Data For The Wrong Year.

AEP Texas' workpapers reveal that AEP Texas relied upon URCS variable costs for the issue traffic using 2000 rather than 2004 URCS costs.[14] As noted above, the Board specifically held that 2004 URCS costs were to be used for all traffic. AEP Texas complied with this directive for all traffic except the issue traffic.

C. AEP Texas' MMM Calculations For Non-Coal Traffic Are Improper.

AEP Texas does not discuss its approach to applying MMM to the many individual movements of non-coal traffic contained in the SARR's traffic group. Its workpapers, however, reveal that AEP Texas simply aggregated all non-coal traffic into eight separate groups by train type.[15] An MMM rate was then assigned to each group, in aggregate, rather than at the movement level. AEP Texas made no effort to distinguish between shippers by origin and destination or by commodity. While the large number of records made it necessary for BNSF to summarize records for shipments of like routing, commodity, and car type, *see* BNSF Opening Fourth Supp. at 33, the broad aggregation process that AEP Texas used ignores crucial differences between shippers and does not generate meaningful MMM rates. Both because AEP Texas' aggregation process is invalid and because AEP Texas offered no justification for its approach, the approach should be rejected.

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[14] *See* AEP Texas Opening Fourth Supplemental Evidence workpaper "TNR Coal Traf and Rev 0100-0603 Reb_ATC_021607_STB ATC_1.xls," worksheet "SUMMARY."

[15] *See* AEP Texas Opening Fourth Supplemental Evidence workpapers "AEP Texas MMM Model - 2005 and 2006 CAPM.xls," "AEP Texas MMM Model - 2006 CAPM.xls," and "AEP Texas MMM Model - All CAPM.xls" under General Freight on each MMM worksheet. The eight BNSF train types used by AEP Texas were: High Priority Manifest (H), Regular Priority Manifest (M), Premium Service Intermodal (P), Guaranteed Service Intermodal (Q), Stack Intermodal (S), Unit Train Other Than Coal or Grain (U), Vehicle (V), and High Priority Intermodal (Z).

D. AEP Texas' Quarterly MMM Calculations For 2000 Through 2003 Are Improper.

AEP Texas reports quarterly MMM rates from 2Q 2000 through 2003 and then switches to annual rates. There is no explanation for why it would be appropriate to use one method for some periods and another method for other periods. In addition, AEP Texas' workpapers reveal that the quarterly rates are not calculated properly. In making its calculations, AEP Texas escalated costs on a quarterly basis, but calculated quarterly revenues by dividing annual revenues by four.[16] This creates an inappropriate mismatch between costs that increase quarterly and revenues that are assumed to remain flat from quarter to quarter. The Board should follow BNSF's approach of calculating annual MMM rates for all periods.

E. AEP Texas' Presentation Of "Maximum Rates" Makes No Sense.

Table 8 of AEP Texas' Opening Fourth Supplemental Evidence sets out its maximum rate calculations for the issue traffic. AEP Texas offers no explanation of the calculations presented or support or justification for the assumptions underlying those calculations. AEP Texas' purported maximum rate calculations raise several issues.

First, AEP Texas sets forth a "jurisdictional threshold" that does not vary by mine.[17] Jurisdictional thresholds must be calculated for individual mines as the variable cost to serve

[16] *See* AEP Texas Opening Fourth Supplemental Evidence workpapers "AEP Texas MMM Model - 2005 and 2006 CAPM.xls," "AEP Texas MMM Model - 2006 CAPM.xls," and "AEP Texas MMM Model - All CAPM.xls," and Column G on each quarterly MMM worksheet.

[17] This "jurisdictional threshold" is also projected until 2020 and is based on restated URCS costs for 2000 through 2006. Both of these steps would be inappropriate in the calculation of a real jurisdictional threshold that applied to an individual mine. As BNSF pointed out in its Fourth Supplemental Evidence, the calculation of the jurisdictional threshold is not an issue that was raised on reconsideration and is not a proper issue to be addressed in this supplemental evidence. If the Board decides that a maximum rate should be prescribed, the Board will need to address the previously submitted evidence on how to determine the jurisdictional threshold, as well as the application of the statute of limitations for certain historical periods.

mines differs. *See, e.g., Wisconsin Power & Light v. Union Pacific Railroad Company*, STB Docket No. 42051, slip op. at 33-36 (STB served Sept. 13, 2001) (prescribing different maximum rates for Black Thunder and Antelope mines due to different jurisdictional thresholds for the mines). The Board is without jurisdiction to prescribe rates that are below the jurisdictional threshold for an individual mine.

Second, AEP Texas presents an "MMM Rate" that would apparently apply to all mine origins. As discussed above, prescribing a single rate across mines that have different variable costs is inconsistent with the fundamental assumptions of MMM and would produce distorted MMM rates.

Third, AEP Texas presents a "Maximum Rate" column in which it identifies a "Maximum Rate" that is in some instances less than the "jurisdictional threshold" it reports. If the reported "jurisdictional threshold" were a meaningful number, which it is not, the "Maximum Rate" could not be less because the Board lacks jurisdiction to prescribe a rate at a level lower than the jurisdictional threshold level.

F. Summary Of MMM Rates

As was the case with the SAC results presented in BNSF's Fourth Supplemental Evidence, if the Board adopts the cost of capital approach advocated by BNSF, there is no overcharge under the modified SAC results reported above and thus no need to apply MMM. Under alternative scenarios one and two, again as restated above, there would be overcharges during at least some years of the prescription period. BNSF has therefore applied MMM to the modified results for each of the two alternative cost of capital scenarios. The MMM results for these alternative scenarios were calculated in the same manner and using the same methodologies as described in BNSF's Fourth Supplemental Evidence. The tables below report

results for Jacobs Ranch mine, the only mine with shipments projected in every year, and results for other issue traffic mine origins are reported in BNSF's workpapers.[18]

Table 4[19]
MMM Results Under First Alternative Scenario

<table>
<tr><th>Year</th><th>MMM Rate</th><th>Jurisdictional Threshold</th><th>Maximum Rate</th></tr>
<tr><td>2000</td><td>$14.07</td><td>$14.97</td><td>$14.97</td></tr>
<tr><td>2001</td><td>13.72</td><td>16.14</td><td>$16.14</td></tr>
<tr><td>2002</td><td>13.14</td><td>16.20</td><td>$16.20</td></tr>
<tr><td>2003</td><td>16.22</td><td>17.11</td><td>$17.11</td></tr>
<tr><td>2004</td><td>18.51</td><td>17.44</td><td>$18.51</td></tr>
<tr><td>2005</td><td colspan="3" rowspan="7">SARR Revenue Requirements Exceed Revenues in Each Year

No Rate Reductions</td></tr>
<tr><td>2006</td></tr>
<tr><td>2007</td></tr>
<tr><td>2008</td></tr>
<tr><td>2009</td></tr>
<tr><td>2010</td></tr>
<tr><td>2011</td></tr>
<tr><td>2012</td><td>20.09</td><td rowspan="9">To Be Determined</td><td rowspan="9">Higher of MMM Rate or Jurisdictional Threshold</td></tr>
<tr><td>2013</td><td>20.25</td></tr>
<tr><td>2014</td><td>20.74</td></tr>
<tr><td>2015</td><td>21.68</td></tr>
<tr><td>2016</td><td>21.90</td></tr>
<tr><td>2017</td><td>21.80</td></tr>
<tr><td>2018</td><td>21.75</td></tr>
<tr><td>2019</td><td>21.64</td></tr>
<tr><td>2020</td><td>21.05</td></tr>
</table>

[18] The traffic at issue in this case does not include movements originating at the Rawhide mine. *See September 2007 Decision* at 4 ("we are denying AEP Texas' request to amend this complaint to extend to the Rawhide movements").

[19] BNSF Fourth Supplemental Reply workpaper "TNR MMM Model DCF CAPM Hybrid LH Reply.xls."

Table 5[20]
MMM Results Under Second Alternative Scenario

Year	MMM Rate	Jurisdictional Threshold	Maximum Rate
2000	$11.23	$14.97	$14.97
2001	10.79	16.14	16.14
2002	10.31	16.20	16.20
2003	11.31	17.11	17.11
2004	12.04	17.44	17.44
2005	15.69	19.85	19.85
2006	17.04	21.13	21.13
2007	15.87	21.34	21.34
2008	16.50	To Be Determined	Higher of MMM Rate or Jurisdictional Threshold
2009	15.68		
2010	15.86		
2011	15.37		
2012	13.85		
2013	14.01		
2014	14.31		
2015	14.86		
2016	15.00		
2017	15.00		
2018	15.10		
2019	15.20		
2020	15.12		

[20] BNSF Fourth Supplemental Reply workpaper "TNR MMM Model CAPM LH Reply.xls."

VI. CONCLUSION

For the reasons stated above and in BNSF's Fourth Supplemental Evidence, the Board should continue to calculate the SARR's historical years' cost of capital using the railroad industry cost of capital determined by the Board in its annual proceedings and should forecast the SARR's future years' cost of capital based on an average of all relevant historical years. Under those assumptions, the challenged rates do not exceed a reasonable maximum rate and the complaint should be dismissed.

Respectfully submitted,

_____

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September 5, 2008

WITNESS VERIFICATIONS

1. Michael R. Baranowski

Michael R. Baranowski sponsored evidence that BNSF filed with its Reply Evidence on May 24, 2004, and his qualifications are described therein.

For the Fourth Supplemental Reply Evidence, Mr. Baranowski is sponsoring evidence relating to application of the Board's DCF model and SAC calculations contained in Section IV.

Mr. Baranowski has signed a verification of the truth of the statement contained therein and a copy of his verification is attached hereto.

2. Benton V. Fisher

Benton V. Fisher sponsored evidence that BNSF filed with its Reply Evidence on May 24, 2004, and his qualifications are described therein.

For the Fourth Supplemental Reply Evidence, Mr. Fisher is sponsoring evidence relating to application of MMM in Section V.

Mr. Fisher has signed a verification of the truth of the statement contained therein and a copy of his verification is attached hereto.

3. John C. Klick

John C. Klick sponsored evidence that BNSF filed with its Reply Evidence on May 24, 2004, and his qualifications are described therein.

For the Fourth Supplemental Reply Evidence, Mr. Klick is sponsoring evidence relating to application of MMM in Section V.

Mr. Klick has signed a verification of the truth of the statement contained therein and a copy of his verification is attached hereto.

CERTIFICATE OF SERVICE

I hereby certify that on this 5th day of September, 2008, I have served six copies of the foregoing Fourth Supplemental Reply Evidence of BNSF Railway Company on the following by hand delivery:

Kelvin J. Dowd
Christopher A. Mills
Daniel M. Jaffe
Slover & Loftus
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_____
Aric A. Anderson